MOORE Kingston Smith

CASH EXTRACTION FOR SMES

Cash extraction

One of the most important issues to be considered for small and medium sized companies is when and how cash should be extracted into the hands of the owners.

There are many areas to consider:

- What are the requirements of individual shareholders in both the short and long term?
- How much cash should you be retaining in the business?
- What is the best way to balance the competing interests of shareholders and key employees without an equity stake?
- Which method will suffer the least tax?

Although tax can only ever be part of the equation, it is an important part and an area where we are frequently asked to advise our clients.

Salary or dividend?

The most common question we are asked is whether it is more efficient to extract cash through a salary or dividend payment.

In broad terms, salary is tax deductible in the company, meaning it will save corporation tax at between 19% and 25% depending on the level of the company's profits. Salary is then paid to employees after the deduction of income tax and national insurance.

Dividends are paid to the shareholders of a company out of taxed company profits. Income tax on dividend payments is usually collected through the self-assessment tax return.

For income which is not covered by the personal allowance (£12,570 in 2023/24, but abated where income is between £100,000 and £125,140) or the dividend allowance (£1,000 in 2023/24), income tax is charged at the following rates:

2023/24		
Taxable income band	Salary	Dividends
Basic rate- up to £37,700	20%	8.75%
Higher rate - £37,701 to £125,140	40%	33.75%
Additional rate - above £125,140	45%	39.35%

When all the various taxes (income tax, national insurance contributions, and corporation tax) are considered, the total effective tax rates that apply on extracting income into the hands of higher rate and additional rate taxpayers (ignoring the effect of the personal allowance and dividend allowance) are as follows:

Company subject to Corporation Tax at 19% (2023/24)		
	Higher rate taxpayer	Additional rate taxpayer
Salary	49.03%	53.43%
Dividend	46.34%	50.87%

Company subject to Corporation Tax at 25% (2023/24)		
	Higher rate taxpayer	Additional rate taxpayer
Salary	49.03%	53.43%
Dividend	50.31%	54.51%

Whether it is more tax efficient to pay salary or dividend therefore depends on the specific circumstances and must be considered on a case by case basis.

Interest or rent

To the extent that a shareholder/director has loaned money to the company, or owns a property that is occupied by the company, the payment of interest or rent will also result in the extraction of cash from the company. This amount will be subject to income tax, but not national insurance contributions, in the hands of the recipient. Provided that the interest and/or rent is incurred and paid on a commercial basis, the presumption is that the expenditure will be deductible for corporation tax purposes.

Where a company pays interest to an individual, it must, in most circumstances, deduct income tax at 20% and pay this to HMRC, and submit returns on a quarterly basis.

The receipt of rent from a company by a shareholder can have implications on the availability of Business Asset Disposal Relief for capital gains tax purposes on the future disposal of the property.

Pension contributions

The company can also make pension contributions on behalf of employees and directors.

Pension contributions should be viewed as part of an individual's total remuneration package and should be reasonable in light of the duties performed for the company. Subject to this, they should be deductible for corporation tax purposes, but it is important to note that the company can only obtain a corporation tax deduction when the contribution is paid into the pension fund, not when it is accrued in the accounts of the company.

A tax charge will arise on an individual when pension contributions exceed the annual allowance, with the standard annual allowance having increased from £40,000 to £60,000 for the 2023/24 tax year. Notwithstanding this, pension contributions can be a very efficient method of cash extraction, although it should be noted that pension benefits may not be available until some years down the line and they will generally be taxed when they are taken.

Tax efficient benefits

Companies may also seek to make the most of other tax exempt or tax efficient employment benefits. Some examples of the many such benefits include:

- The provision of a mobile phone;
- The provision of interest-free or low-interest loans, provided the total amount outstanding on all such loans is less than £10,000;
- The 'Cycle to work' scheme, where bicycles and associated safety equipment are provided under a salary sacrifice arrangement to employees under specified conditions;
- The provision of electric or ultra-low emissions cars (for instance, the provision of a car with no CO_2 emissions and with a list price of £30,000 will give rise to a taxable benefit of £600 in 2023/24); and
- The provision of workplace charging facilities for electric cars.

Paying other family members

Some business owners ask about the possibility of paying salaries or providing benefits to another family member, such as a spouse or child who might be a non (or basic rate) taxpayer. This might be worth considering, but it should be noted that, to be supportable from a tax point of view, an individual's total remuneration package should be reasonable in light of the work performed for the company.

Other comments

It is likely that the best way of extracting cash from an SME will entail a combination of a number of the approaches described above. In any extraction policy, there are certain things which must be borne in mind:

- Paying a certain level of salary will preserve the national insurance contributions record for that year, and so give the right to certain benefits, including the state pension. For 2023/24 the minimum level is £6,396.
- The amount that can be contributed tax efficiently to a pension scheme each year is the higher of earnings and £3,600, subject to the annual allowance. Dividends do not count as earnings for this purpose and, therefore, a low salary can affect your capacity to save for your retirement.
- Payment of a low salary can mean falling foul of the National Minimum Wage regulations and risking a fine or other penalty.
- Where life assurance or death in service policies are based on a multiple of salary or earnings, the payment of a low salary could result in benefits at a lower level.
- Some banks are only willing to lend on the basis of salary, so low salary payments can have an effect on your ability to take out a mortgage or other loan finance.

Contact us

Call:
+44 (0)20 4582 1000

Or email:
pd@mksco.uk